RESPONSE TO QUESTION OF SENATOR DODD

Hearing of April 17, 1985

Question 1. The credit provisions of the Securities Exchange Act of 1934 and the credit restrictions of Regulation T of the Federal Reserve Board were designed to help prevent the excessive use of credit in the securities markets, which had contributed to the collapse of the financial system of the country in 1929. Now the proposed SEC rule relating to the permitted use of mandatory installment payments in connection with the purchase of publicly offered limited partnership interests would overturn prior regulation in the area. I understand that both the industry and the state securities regulators are opposed to this change. Would you please tell us what the Commission rationale is for proposing the change?

Answer. Since 1972, the Board of Governors of the Federal Reserve System ("Board") has taken the interpretive position that a broker-dealer that participates in the public sale of limited partnership interests on an installment basis is "arranging" for the extension of credit in violation of Section 7(c) of the Exchange Act and Regulation T thereunder. The Commission's staff has generally taken a similar position under Section 11(d) of the Exchange Act which prohibits a broker-dealer from extending or arranging for credit in a distribution of a new issue of securities.

In the intervening years, the merits of permitting installment sales in public offerings of limited partnership interests has been intensely debated within the securities industry. On several occasions, most recently in April 1983, the National Association of Securities Dealers, Inc. ("NASD") formally petitioned the Board to re-examine its position, and proposed several conditions designed to protect investors that could apply to any exemption from the prohibition. The NASD argued that lifting the prohibition on installment sales would benefit public investors by permitting them to retain the use of funds not presently needed by the partnership rather than have those funds invested by the partnership. In addition, the NASD noted that the present ability to offer installment sales only in private placements in effect foreclosed participation in those investment opportunities by investors who could not meet the "accredited investor" standard of Regulation D. After extensive consultation between the Board and Commission staff, it appeared that the most efficient way to expose the issue for public scrutiny was for the Commission to propose a rule pursuant to its authority under Section 3(a)(12) of the Exchange Act.

The Commission's rule, which was published for comment in November, 1984 (Release No. 34-21495), would permit installment sales if:

- The securities are registered under the Securities Act of 1933;
- The issuer registers the securities under Section 12(g) of the Exchange Act and the securities remain so registered until the total purchase price of the security is paid; and
- The mandatory installment payments bear a direct relationship to the cash needs and program objectives described in a business development plan disclosed in the registration statement filed with the Commission.

The Commission believed it was important to allow the securities industry and other persons with an interest in this issue to publicly state their views, both positive and negative. The Commission received 124 comment letters, with 57 supporting, and 67 opposing, the Rule. Those in support included the Securities Industry Association and its Limited Partnership and Direct Investment Committee, which is comprised of both small and large broker-dealers, the NASD, fifteen program sponsors and

several bar associations, including the American Bar Association. Those opposed included the National Association of Realtors, and its affiliate, the Real Estate Securities and Syndication Institute, which includes persons involved in all aspects of the real estate business, some members of these groups in their individual capacities, the North American Association of Securities Administrators, and Senators Jake Garn and Alphonse D'Amato.

The staff of the Commission is currently in the process of analyzing the comments received. The staff is also exploring the tax implications of the proposal with the staff of the Internal Revenue Service. After the staff has concluded its analysis it will forward a recommendation to the Commission for further action on the proposed Rule.

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Question 2. While the Commission has argued that the rule would result in increased investor protection because numerous private offerings which are now exempt from the Securities Act registration provisions would register with the SEC, others have contended strenuously that the rule would have disastrous effects. Because the other view is in such stark contrast, I'd like to present it in considerable detail for your response.

Opponents of the proposed rule argue that there would be an unwarranted expansion of credit in the financial marketplace and widespread use of credit in the form of installment payments by investors purchasing securities which would increase the risk of financial collapse of our economy. Furthermore, they argue that it is unlikely that there will be an increase in public registration because that is a time consuming and costly process. Instead, it is argued that the rule would create unnecessary additional risks for the investing public. They say that small investors, who are the typical investors in publicly offered limited partnerships, may not be able to anticipate future needs and thus may be encouraged to default in making their future payments, especially in times of recession. They say that the use of installment payments will result in

increased tax write-offs as a percentage of the investors' cash contributions during the installment period, thereby allowing securities brokers to sell a deeper tax shelter to investors than is presently available in public partnership offerings. It is contended that this will cause issuers of these securities to pay less attention to the economics of the underlying investments and result in a decrease in revenues to the U.S. Treasury since tax write-offs will accelerate with no corresponding increase in the economics of investments. Finally, it is argued that the use of installment payments is likely to contribute to an unrealistic and unstable real estate market due to artificially higher prices being paid for real properties which might be purchased solely for tax reasons.

This is a very bleak view of the consequences of your proposed rule. What is your response to these concerns?

Answer. Each concern cited is addressed below. It should be noted, however, that the staff has not concluded its analysis of these concerns and that these responses are preliminary in nature.

- The rule would permit an unwarranted expansion of credit in the financial marketplace.

* The proponents of the rule argue that installment sales do not contravene any of the purposes enunciated by the Congress when it adopted the credit restrictions, including the prevention of the excessive use of credit for the purchase or carrying of securities. In that regard, they contend that staged payments for interests in the type of direct participation programs covered by the rule (i.e., those where payments bear a direct relationship to the cash needs and program objectives disclosed in the registration statement) do not involve an extension of credit, but instead are more closely analogous to payments for work in process, made when and as the work is performed.

In addition, a prediction that the amount of "credit" extended through staged payments would increase the risk of financial collapse appears highly questionable. As noted in the recent Federal Reserve Board margin study, the ratio of security loans at banks to total bank credit and the ratio of all security loans relative to the aggregate of all credit in the economy have declined substantially on balance over the past 50 years and may account for only a small percentage of each of these broad measures of credit. Therefore, while the Commission will carefully consider concerns over

potentially increased investor default and possible adverse effects of those defaults on partnerships, more widespread effects on the economy appear speculative.

Another purpose of the credit restrictions is to prevent excessive speculation in the securities markets. Some commentators pointed out that the sale of direct participation securities is not characterized by fluctuation in securities prices. Program securities are generally purchased as long-term investments since there is no active secondary market.

- It is unlikely that there will be an increase in public registration because that is a costly and time consuming process.

* Proponents of the rule argue that because installment payments are currently available only in private offerings, many investors are denied the opportunity to participate in such programs although many would like to do so. To the extent there is such investor interest, registration with the Commission would be cost effective.

- The rule would expose investors to additional risks; possibility of default of investors on future payments.

* Proponents of the rule argue that in 1972 when installment sales in public offerings were first prohibited, there was

little regulation of direct participation programs. Since then, the states and the NASD have developed specific regulations to determine the fairness and reasonableness of program offerings. For example, NASD rules and those of most states require broker-dealers selling these securities to make a specific suitability determination for each investor and the broker must have a reasonable basis to believe that the investor has sufficient net worth to sustain the risks inherent in the program. In addition, the Commission has developed additional disclosure and reporting obligations specifically to apply to program offerings. Of course, persons involved in the sale of these securities are fully subject to the antifraud provisions of the federal securities laws.

Finally, installment payments are currently allowed in private placements of securities. The Commission has been informed that currently the number of defaults in making required payments is negligible.

- The rule will result in increased tax write-offs as a percentage of cash contributions during the installment period, thereby allowing securities brokers to sell a deeper tax shelter to investors than is presently available in public partnership offerings. It is contended that this will cause issuers of

securities to pay less attention to the economics of the underlying investments and result in a decrease in revenues to the U.S. Treasury since tax write offs will accelerate with no corresponding increase in the economics of investments.

* The Commission does not have the expertise to provide any in depth analysis of the tax implications of its proposed rule. Lawyers experienced in tax matters, however, have advised the IRS and the Commission in a letter in the Commission's public files of their belief that many of these concerns are not well founded. For example, they argue that deeper tax shelters will not be structured because the Internal Revenue Code ("Code") does not limit the ratio of allowable tax benefits claimed by a limited partner to the amount of cash he contributes to the partnership. Thus, neither the timing (assuming that adequate basis is provided to the limited partners as a result of partnership level borrowings incurred to acquire the property) nor the total amount of tax benefits available to limited partners of a partnership owning depreciable real estate is affected by the timing of limited partners' capital contributions.

These persons also argue that the use of installment sales will not encourage tax shelter promoters to structure abusive

transactions because the rule would merely permit a new type of financing without changing the existing tax treatment of limited partnerships. If such abuses should occur, they argue that the Code provides the IRS with substantial weapons to combat non-economic or abusive transactions.

- The use of installment payments is likely to contribute to an unrealistic and unstable real estate market due to artificially higher prices being paid for real properties which might be purchased solely for tax reasons.

* In the same letter referred to above, tax lawyers have advised the IRS and the Commission that to the extent this concern is addressed to tax-motivated overpayments for real estate acquired for syndication, they believe that the Service has substantial weapons (e.g., the Code §6659 penalty for valuation overstatements and the Code §6621(d) increased interest rate on substantial underpayments attributable to tax-motivated transactions) with which to combat overvaluations of real estate intended to generate increased tax benefits. Also, because of the more onerous disclosure, liability and penalty provisions applicable to registered offerings under the 1933 Act, they think that the proposed rule would make it even less likely that overvaluations of real estate would occur than may be the case today.